No. 04-252

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IN THE

Supreme Court of the United States

MACY'S EAST, INC.,
Petitioner,

v.

COMMISSIONER OF REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Judicial Court of Massachusetts

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BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

DIANN L. SMITH, General Counsel
DOUGLAS L. LINDHOLM, *
President
STEPHEN P.B. KRANZ, Tax Counsel
BOBBY L. BURGNER, Chair
J. HUGH MCKINNON, Counsel
LAWYERS' COORDINATING
SUBCOMMITTEE
COUNCIL ON STATE TAXATION
122 C St., N.W., Suite 330
Washington, D.C. 20001
(202) 484-5215

* Counsel of Record

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

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INTEREST OF THE *AMICUS CURIAE*

The Council On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above-captioned matter.[1]

COST is a non-profit trade association formed in 1969 to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. In that role COST monitors and works to improve the fairness and rationality of state and local business taxes. COST repre-

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner has been obtained and filed with the Clerk of the Court.

sents nearly 600 of the largest corporations in the United States, including companies from every industry segment.

Each of the 45 states that imposes a form of corporate income tax has some provision addressing "net operating losses"—the concept at issue in this case. The vast majority of COST members have been subject to a state NOL regime at one time or another. All COST members have an interest in ensuring fair, well-functioning tax systems which incorporate the NOL concept without running afoul of basic constitutional principles. As evidenced by this case, the position taken by the Massachusetts Department of Revenue does not serve this interest, to the disadvantage of COST's members.

SUMMARY OF THE ARGUMENT

The instant case is deserving of review by this Court because: a) as a general legal matter, the greater business community is significantly concerned about the misuse of NOL provisions by state judges, state tax administrators, and state legislatures; and b) in this case specifically, the Commonwealth of Massachusetts has violated the Due Process Clause and the Commerce Clause of the United States Constitution. The state may not define taxable income to in clude income from previously non-taxable non-Massachusetts stores in its apportionable base, while at the same time excluding losses from those same stores.

As noted in Petitioner's brief, during the years in issue, Macy's East operated the same business in Massachusetts and elsewhere as had been operated by its predecessors for over 100 years. Macy's East was formed as a result of the bankruptcies and successful rehabilitation of two separate retailers, Federated Department Stores, Inc. and R.H. Macy & Co. Macy's East represented the consolidation of previously separately incorporated regional stores in Massachusetts and elsewhere. During their years of operation as separate corporations, until their mergers into Macy's East, the non-Massachusetts consolidated stores had accumulated signifi-

cant NOLs. During the years at issue, the entire Massachusetts taxable income was earned outside Massachusetts through the operations of these non-Massachusetts consolidated stores. In calculating its Massachusetts corporate income tax, Macy's East sought to use the accumulated NOLs against the income generated by these non-Massachusetts consolidated stores. The Massachusetts Department of Revenue, as upheld by the Massachusetts courts, denied Macy's East the ability to use the NOL carryovers from the consolidated stores which generated the income on the theory that the NOLs were not generated by Macy's East itself. It is this denial of the NOLs which is at issue here.

ARGUMENT

I. THE BUSINESS COMMUNITY IS CONCERNED ABOUT THE MISINTERPRETATION OF NOLS BY STATE JUDGES, STATE TAX ADMINISTRATORS, AND STATE LEGISLATURES.

The case is worthy of review by the United States Supreme Court because of its implications beyond the immediate taxpayer and the immediate law at issue. In the recent past, utilization of NOLs has been under attack from a variety of sources including state judges, state tax administrators, and state legislatures. In most instances, these attacks are premised upon a fundamental misunderstanding of the function and form of NOLs. Review by this Court is critical in reversing this now widespread misunderstanding of a basic concept to the corporate income tax system.

What are NOLs? Simply, a NOL occurs when a business's expenses exceed its income in a given year. The United States corporate tax system is based on a twelve month reporting period. Thus, every twelve months corporate taxpayers must add up their deductions and income to determine their taxable income. However, and as is patently obvious, businesses themselves do not operate neatly on a twelve

month cycle. In the early years of a new business (or new product), the company may need to expend significant resources to become a going concern, and it may have high deductions but low (or no) income. The result is several years of losses. These early investments are the building blocks to future income. The federal and state tax codes have long recognized that a proper matching of income and expenses allows for the carryover of early NOLs to offset the later income that was generated directly as a result of the early deductions.

The current environment unfortunately has encouraged many state tax administrators to abandon or ignore fundamentally sound precepts of corporate tax law. Among many state tax administrators today, NOLs are seen as merely another corporate give-away. At best, a government tax administrator may view NOLs as just another incentive created to give businesses a tax break in the state to promote jobs or other beneficial but not tax related activities. At worst, a government administrator may see NOLs as an improper loophole by which businesses are escaping their obligation to society to pay their "fair share."[2] Neither characterization could be further from the truth. While an NOL is technically a deduction, it is in reality a unique tax calculation that is necessary to even out the random effects of using a twelve-month income reporting system. Thus, far from being a special business gift, NOLs are in fact inseparable from the calculation of the concept of profit that is the underlying basis for the corporate income tax. The Massachusetts Department of Revenue, like several other state tax administrators, has failed to recognize this unique aspect of the NOL deduction and thus has failed to administer its corporate income tax system in a fair and equitable manner as envisioned by the underlying tax statute.

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[2] North Carolina's "Efficiency and Tax Loophole Closing Commission", Tax Loopholes Spreadsheet, March 16, 2001.

Start-up expenses are not the only example of the inappropriateness of forcing the business cycle into a 12 month reporting cycle. Several years of recessions may give way to several years of prosperity. Such economic swings would result in long-term over taxation of total corporate income if losses were not allowed to be carried over from the recession years to the boom years. These are but two examples of the policy behind the universal acceptance among tax professionals of the appropriateness, in fact the necessity, of the con cept of NOLs and the attendant carryover. Hence, contrary to recent inflammatory commentary, NOLs are not a tax "loophole" but instead have been specifically recognized as a tax accounting tool necessary to alleviate the inherently arbitrary results which occur when annual reporting periods are used to measure income.

Nevertheless, NOLs are under attack from numerous sources due to the recent state economic crisis and the low respect in which business is held due to the dismal wave of business scandals. Numerous instances abound of state tax administrators purposefully distorting the net operating loss deduction statute to improperly increase revenue at the expense of taxpayers and sound tax policy. For example, the Connecticut Commissioner of Revenue, without statutory authority, is attempting to eliminate deductions related to intangible property paid to an affiliate if that affiliate has carry-over losses that eliminate its tax liability in other states. Connecticut Form CT-1120AB, Add- Back and Exceptions to Add-Back of Interest and Intangible Expenses. In Alabama, the Commissioner of Revenue denied NOL carryback to a dissolving company which would otherwise never be able to use the deduction (*WWD, Incorporated v. Alabama Dept. of Revenue, Dept. of Revenue*, Admin. Law Division, Docket No. Corp. 04-149 (6/15/04)(overturned by the Alabama ALJ)). A large pharmaceutical company is under attack by numerous state tax commissioners for attempting to use pre-bankruptcy NOLs. *See Am. Home Prod. Corp. v. Tracy*, 787 N.E.2d 658

(2003); *A. H. Robins Co. v. Dir., Div. of Taxation*, 20 N.J. Tax 338 (N.J. Tax Ct., 2002), *aff'd A.H. Robins Co. v. Dir., Div. of Taxation*, 365 N.J. Super. 472 (N.J. Super. Ct., 2004)). Complicated discussions are occurring at the Multistate Tax Commission—an association of twenty-three states—regarding how to properly account for NOLs among affiliated companies filing a unitary combined return. These are but a few of the dozens and dozens of cases and issues currently pending across the country seeking to arbitrarily limit the use of legitimate and statutorily authorized NOLs.

COST is **not** challenging a **legislature's** ability to limit or prohibit NOLs by statute or to prohibit NOLs unrelated to income taxable in the state. Even though the complete disallowance of NOLs is inconsistent with sound tax policy principles, state legislatures clearly have the authority to enact bad tax policy if they so choose (as long as it does not run afoul of federal or constitutional limitations). However, while other state legislatures have clearly and legally limited the use of NOLs,[3] the Massachusetts legislature has not. Instead—and what is offensive in this case—is that the Massachusetts Department of Revenue took it upon itself to limit the use of NOLs. The result is the creation of bad tax policy that was never intended nor endorsed by the Massachusetts legislature. Other state tax administrators, as noted above, are following a similar destructive path. Such mismanagement of the vital function of extracting financial resources from business is not something that should be calmly ignored.

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[3] *See e.g.*, N.J. P.L. 2004, Ch. 47 (NOL carryover limited to 50 percent reduction in entire net income for 2004 and 2005); CA Sec. 24416.3, Rev. & Tax. Code (no net operating loss allowed for taxable years beginning in 2002 and 2003); *see also* "Current And Quotable: States Could Avoid Revenue Loss In Current Fiscal Crisis By Disallowing Business Operating Loss Carrybacks", 2003 State Tax Notes 101-3 (5/22/03).

The mismatch between past losses and future income is further exacerbated here by the intervening bankruptcy. As discussed in Petitioner's Brief (pp. 13-16), the largest assets a bankrupt estate may have are its NOLs. Thus, one of the main assets that the consolidated companies held upon emergence from bankruptcy is completely ignored by Massachusetts in calculating the tax upon the income generated in relation to those assets.

Perhaps this Court could overlook state tax administrator hostility toward perfectly legitimate NOLs if the case now before the Court was itself but one, isolated example of a state revenue department superceding both its legislative authority and basic sound tax policy. However, and unfortunately for business taxpayers across the country, this is not an isolated case. At least one other COST member has a similar case on hold in Massachusetts pending resolution of this case, and Massachusetts is not an isolated state as far as this specific fact situation. One COST member which does business in all 50 states—one of the most recognized and respected companies in the country—is being subjected to an almost identical and equally egregious situation in Tennessee regarding its ability to use its NOLs. Thus, far from representing an anomaly in how this taxpayer happened to do business at one period in time, this case represents a continuing problem affecting businesses across the country and across industry groups. Hence, this Court is not only the most efficient forum to resolve this issue, at this point it is the only forum that may resolve an issue which is taking a real financial toll on taxpayers throughout the country.

II. UNDER THE DUE PROCESS CLAUSE AND THE COMMERCE CLAUSE, MASSACHUSETTS MAY NOT DEFINE TAXABLE INCOME IN SUCH A WAY AS TO INCREASE ITS TAX BASE BY INCLUDING INCOME FROM NON-MASSACHUSETTS STORES IN THE APPORTIONABLE TAX BASE BUT NOT INCLUDING LOSSES FROM THOSE SAME STORES.

While NOLs may be under attack generally, this would probably not be enough to engage this Court's analysis if it were not that Massachusetts's actions in this particular case violated the Due Process Clause and the Commerce Clause of the United States Constitution. Massachusetts's violation comes from including only the income, but not the deductions, of the acquired corporations. This creates an apportionment and a discrimination problem in the sense that the income and losses of in-state stores are accounted for in the tax base but only the income, not the losses, of the out-of-state stores represented by the acquired corporations is included in the tax base.

As noted in the Petitioner's brief, this case arose because of a consolidation among the various regional corporations of Petitioner's national retail operations. Pet. Brief pp 5-8. As a result of the consolidation, retail stores that were not previously subject to tax in Massachusetts became subject to tax. These newly consolidated stores were, during the years at issue, the only part of the taxpayer's business that was profitable. The Massachusetts stores were not profitable and contributed nothing to the taxable income base in Massachusetts. The newly consolidated stores, however, had previously struggled financially and had NOLs resulting from those earlier, pre-consolidation, difficult years. As a result of the consolidations Massachusetts was able to include the profits of the consolidated stores in its income base and, thus, effectively taxed those stores. Because Massachusetts is a

separate filing state,[4] if it were not for the consolidations of the stores, Massachusetts would never have been able to tax the income from the non-Massachusetts stores.[5] Yet it is exactly this consolidation—which directly increased Massachusetts tax, that Massachusetts relies on to disallow the consolidated companies' losses from offsetting any of the Massachusetts income.

It is important to note that this is not a situation in which a profitable taxpayer seeks to shelter its income through the acquisition of an unrelated business with large net operating losses. Such a situation is abusive and is easily rectified through the imposition of such requirements as the continuity of business doctrine so carefully articulated in *Libson Shops*.[6] To the contrary, this is a situation in which all of the income Massachusetts seeks to tax is generated from the exact same business, in fact the exact same stores, that previously generated the disallowed losses. This is a classic situation in which the losses should be allowed to smooth out the randomness of using a twelve-month reporting cycle.[7] The retail stores had

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[4] A separate filing state can be distinguished from a state that allows combined or consolidated reporting. In a separate filing state, each separately incorporated entity files its own tax return. Very generally, in a combined or consolidated state, affiliated entities combine their income, deductions, and apportionment factors to arrive at a single tax base for that state for all affiliated entities. If Massachusetts had been a combined or consolidated state, the income and losses of the southern stores would have been included in Massachusetts's tax base even in the earlier years.

[5] See *Polaroid v. Commissioner of Revenue*, 393 Mass. 490 (1984) (Massachusetts "unitary principle" is limited to the separate company context).

[6] *Libson Shops, Inc. v. Koehler*, 77 S.Ct. 990 (1957).

[7] Further, this is not a situation in which a company was previously not taxable (no nexus) in a state during the years in which the NOLs were incurred, but seeks to use those losses against newly generated income upon the opening of some new facility or project in the taxing state. In such a situation, the relationship between the out-of-state income is much

previously struggled financially and are now back on their feet. The income cannot be seen in isolation. It should only be seen as a result of weathering a difficult financial period, incurring significant losses to make it through that period, and now reaping the benefits of that success through positive profits.

Massachusetts violates Due Process and the Commerce Clause by taxing solely the income but not the losses of the out-of state stores. The Massachusetts Legislature could probably have simply disallowed all NOLs for all companies without creating a violation of the United States Constitution. Such a disallowance, while bad policy, is within the purview of the legislature because it merely changes the tax base for everyone. However, that is not what Massachusetts did. First, the Massachusetts Legislature did not disallow NOLs at all. As noted by Petitioners, it was the Department of Revenue that overreached its authority granted under the statute and interpreted the taxing statute contrary to its plain language. Further, the Department itself did not disallow NOL deductions for everyone; it only disallowed them to the extent they were incurred by an acquired company. In this case, because of the geographic make-up of the taxpayer, the result was that Massachusetts taxed income over which it previously had no jurisdiction, while at the same time denying a deduction for NOLs that were incurred by the direct predecessor of such income. Massachusetts, under the Commerce Clause fair apportionment and non-discrimination

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more attenuated. In the case at hand, however, the losses and the income were related to the exact same facilities. It was merely a legal change in structure that under the Massachusetts Department of Revenue's theory caused losses to be separated from the income. While legal restructuring should be recognized, Massachusetts only recognized it in so far as it increased the geographical reach of the income subject to tax in the state but not to the extent such restructuring also impacted the losses. As COST has continually emphasized, a state should not be able to have it both ways.

prongs, cannot pick and choose what part of a taxpayer's operations it wants to tax.

CONCLUSION

For the reasons stated above, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

DIANN L. SMITH, General Counsel
DOUGLAS L. LINDHOLM, *
President
STEPHEN P.B. KRANZ, Tax Counsel
BOBBY L. BURGNER, Chair
J. HUGH MCKINNON, Counsel
LAWYERS' COORDINATING
SUBCOMMITTEE
COUNCIL ON STATE TAXATION
122 C St., N.W., Suite 330
Washington, D.C. 20001
(202) 484-5215

* Counsel of Record